Supreme Court, U.S.
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No. 01-1880

In the
Supreme Court of the United States

WALTER L. AND BARBARA H. GROSS, JR.;
CALVIN C. AND PATRICIA G. LINNEMANN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

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The Commissioner's brief in opposition leaves undisturbed nearly all of Petitioners' legal arguments, opting instead to try to transform the IRS's actions in this case into factbound applications of existing law. Petitioners demonstrated that what the IRS actually did in this case, and what the lower courts condoned, was abandon a longstanding and settled administrative practice in favor of a new theory that the IRS imposed retroactively to increase Petitioners' tax liability. Petitioners demonstrated that the Commissioner's actions violated not only well-settled administrative law and due process principles that have been followed both by this Court and other courts of appeals but also Congress' recent policy statements against retroactive tax liability. The basic theme of the Commissioner's brief in opposition is that the lower court decisions in this case do not condone a legally prohibited IRS attempt to retroactively apply a new valuation methodology for S Corporation stock, but rather merely confirm the fact that tax affecting an S Corporation's income stream has never been an administratively approved, broadly applied component of the willing buyer/willing seller standard of valuation of S Corporation stock. The Commissioner's arguments, however, are not persuasive.

ARGUMENT

Like the decisions below, the Commissioner's brief dutifully recites, but then essentially ignores, the controlling willing buyer/willing seller standard of valuation, opting instead to impose a new administrative interpretation of that standard, retroactively, that it is "absolutely" wrong to tax affect in all S Corporation situations. (Tr. 377, 386-87). Indeed, while the Commissioner now claims that this case turned on certain "factbound" realities and circumstances, even the court of appeals noted that the tax court itself had examined the issues in this case as a "theoretical matter" and

"as a matter of economic theory," not as a matter of fact. (Pet. App. 26a).

1. That what happened in this case was the retroactive imposition of a new legal rule is confirmed by the reality that what the IRS has identified as factually unique about this case is not unique at all. If anything, what the IRS now suggests that it and the lower courts did amounts to an alteration of the willing buyer/willing seller standard itself. The two determinative "factbound" realities emphasized by the IRS and the courts below are that "G&J, as an S corporation, did not pay corporate taxes and that there was no reason to believe that it would lose its S corporation status." (Opp. 13-14). The obvious problem with characterizing G&J's nonpayment of corporate level income taxes as a "factbound" consideration is that freedom from corporate level taxes has always been an essential characteristic of all S Corporations and, indeed, the very reason they were created by Congress. Somewhat less obvious, but equally ill-conceived, is the idea that tax affecting is not proper unless G & J was in some demonstrable jeopardy of "losing" its S Corporation status. The problem with this "factbound" inquiry is that it improperly focuses on the value of the corporation's tax-free income stream to existing owners or, as in this case, S-eligible donees who can succeed to the corporation's tax-free income stream. However, the fact that the donees in this case would likely continue to receive the benefits of corporate tax free income is also not "factbound," but is an inherent characteristic of all financially sound S Corporations.

Even more importantly, the supposed "factbound" approach of the IRS and the courts below in valuing these gifts of G&J stock violates the requirement that the value of a gift of stock is the fair market value on the date of the gift,

based on the price at which it would change hands between a hypothetical willing buyer and a hypothetical willing seller. United States v. Cartwright, 411 U.S. 546, 551 (1973); Mandelbaum v. Commissioner, 69 T.C.M. (CCH) 2852, 2863 (1995). Instead of focusing on the market value of G & J Stock to a "hypothetical" willing buyer – including non-S eligible persons and corporations – as the standard requires, the courts below accepted the Commissioner's improper position that G&J stock should be valued on the assumption that G&J would continue to exist indefinitely as an S Corporation and that the tax advantage to successor shareholders would never be lost. (R. 28, Opinion at 14, 25).

The fundamental problem with this position is that the courts have repeatedly held that the willing buyer/willing seller standard is violated by postulating a special individual or group of buyers or sellers for whom the property has greater value based on their status or relationship to the property or to other relevant parties. Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Estate of Hall v. Commissioner, 92 T.C. 312, 336-337 (1989). Therefore, by assuming only S-eligible buyers for valuation purposes, the IRS and the courts below essentially declined to follow the controlling willing buyer/willing seller standard of valuation for S Corporation stock and have impermissibly, and retroactively as to Petitioners, applied a different methodology in violation of not only well-settled administrative law and due process principles, but also recent policy statements of Congress against retroactive tax liability.

2. In addition to disregarding the fundamental willing buyer/willing seller standard itself, the Commissioner and the courts below dispute the validity and significance of the four factors emphasized by Petitioners as compelling evidence that no reasonably knowledgeable, hypothetical

willing buyer would have purchased G & J stock in July 1992 at a price grossly inflated due to a failure to tax affect its earnings for valuation purposes.

a. The Commissioner's Brief is critical of Petitioners for relying on the Maris and Hall cases as examples of cases in which the Tax Court approved tax affecting, because those cases did not "establish a rule" requiring the tax affecting. (Opp. 17). In a similar vein, the Commissioner criticizes Petitioners' reliance on the IRS's own Examination Handbook and Valuation Guide which advocated tax affecting the earnings of S corporations for valuation purposes. It is argued that these "isolated references" to tax affecting do not rise to the level of an "established tax principle" like the one at issue in Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981). (Opp. 16, fn. 7).[1] These arguments miss two key points. First, it is the clear cumulative impact of the case law, the Commissioner's own publications, the generally accepted practice of the appraisal profession and the recently prior, identical valuations of G & J stock that, taken together, sent the clearest possible message to willing buyers of G & J stock in 1992 that tax affecting was essential to a fair valuation.

b. Second, in contrast to the cumulative weight of the factors supporting the necessity of tax affecting in any valuation between a willing buyer and a willing seller, the Commissioner has failed to cite any other instance, either before 1992 or after 1992 and prior to this decision, in which

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[1] Even aside from Bright, the IRS ignores all of the other cases that Petitioner cited that have rejected attempts by agencies to change informal legal positions in litigation contexts. (See Pet. 12-13).

the IRS has taken the position, on either tax affecting or the lack of marketability discount, that it has taken in this case at the expense of Petitioners. See Estate of Bright v. United States, 658 F.2d at 1003 (noting the government's failure to cite any prior case in which it applied the new theory proffered in that case).[2]

c. Furthermore, the Commissioner and the courts below improperly concluded that Petitioners' evidence failed to support the fact that tax affecting was clearly the generally accepted practice of the appraisal profession in 1992. Only by mischaracterizing the testimony of the experts can the Commissioner say that the record shows a disagreement over whether tax affecting was the generally accepted practice in 1992. (Opp. 14). In fact, the Commissioner's only expert, Mr. Bajaj, who had no actual business valuation experience before 1995 (Tr. 323-327), essentially disqualified himself on the issue by admitting that he simply had no knowledge or information as to the accepted practice of the appraisal profession on tax affecting in 1992. (Tr. 377).

On the other hand, Petitioners' highly experienced business valuation expert, Mr. McCoy, testified without reservation that tax affecting was the general practice of business appraisers when valuing S Corporations in 1992. (Trial Ex.2(m) at 1-2, C.A. App. 399-400; Tr. 195). In addition, Mr. McCoy testified that Uniform Standards of

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[2] In fact, the only other instance that Petitioners have found involving the IRS is the recent post-Gross decision in Adams v. Commissioner, T.C. Memo. 2002-80, 83 T.C.M. (CCH) 1421 (Mar. 28, 2002), which itself cites Gross in support of the IRS's anti-tax affecting position. The Delaware Chancery Court cited by the IRS did not involve the IRS or any of the federal regulations at issue in this case.

Professional Appraisal Practice established by the Appraisal Foundation ethically required him to conduct business appraisals according to accepted methods and techniques, and that a failure on his part to tax affect G&J's earnings in 1992 would have been a violation of his ethical obligation. (Tr. 196-197). On direct and cross examination, Mr. McCoy acknowledged that prior to July, 1992, a "sprinkling" of articles appearing in Business Valuation Review, a periodical magazine for business appraisers, initiated a "growing controversy" about tax affecting S Corporation earnings for stock valuation purposes. (Tr. 197-199, 254, 256, 258-259). Mr. McCoy also agreed that the issue was still being debated in the literature as of the time of trial in November, 1997, and that if he were asked to perform an appraisal of G & J stock as of November, 1997, he would give further thought as to how he would value G & J stock depending on all the facts and circumstances. (Tr. 257, 274). However, Mr. McCoy never wavered from the view that, despite the sprinkling of articles, tax affecting S Corporation earnings for valuation purposes was the generally accepted approach in 1992. (Tr. 199, 254, 256, 273). Moreover, although Mr. McCoy acknowledged that some appraisers might have been using a different valuation method as of November, 1997, he was not personally aware of any business appraisers who did not tax affect S Corporation earnings in 1992. (Tr. 254, 266).

Similarly, Petitioners' other experienced business valuation expert, Mr. Wilhoite, testified that although some members of the appraisal profession were beginning to express different views about the "theoretical impact" of tax affecting before 1992, tax affecting itself was the valuation approach generally being followed by the appraisal profession in 1992. (Tr. 476-479, 496).

Against this backdrop of voluminous and essentially undisputed evidence supporting Petitioner's approach to the valuation of the 1992 gifts of G & J stock, the Commissioner's new valuation methodology sprung on Petitioners in this case defies the common sense that purports to be its hallmark. Consider this. In 1988, gifts of the same G & J stock were valued by Mr. McCoy at $3,900 per share for tax purposes and this tax affected valuation was investigated and accepted by the IRS. (Trial Exs. 17, 18, 19-J, 23-24) In 1990, the stock was again valued by Mr. McCoy for estate tax purposes at $4,910 and this valuation was approved by an IRS Financial Analyst who tax affected G & J's earnings using the same 40% reduction Mr. McCoy used. (Trial Ex. 59 at 7). In 1992, just 2 years later, could a knowledgeable willing buyer be found who would pay a non-tax affected price of $10,910 per share, more than double the 1990 IRS-approved value for the same stock? Yet, that is precisely what the IRS itself has demanded of Petitioners, and even more remarkably, it is precisely what the courts below have decided Petitioners must now do nearly ten years later!

3. The IRS also suggests that even if it did change its position regarding valuation for this case, such a retroactive change in position is permitted under the justification that a taxpayer cannot "avoid payment of a tax rightfully due." (Opp. 17). This is nothing more than question begging. As shown above and in the Petition, the tax cannot be said to be "rightfully due" under a proper interpretation of the willing buyer/willing seller standard. Moreover, to the extent that the IRS is simply repeating the court of appeals "error correction" rationale, Petitioners have already shown that it does not apply.

Specifically, as Petitioners have previously noted, Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220, 1222

(2d Cir. 1975) and similar cases are inapplicable because the Petitioners here are not seeking to perpetuate one plainly erroneous IRS mistake. The IRS's position here, in fact, is schizophrenic, because it has never actually stated that it had been erroneously interpreting the regulations governing the valuation of gifts in the time leading up to the Gross trial. Indeed, it steadfastly denies that any change in position actually occurred.

In any event, the IRS is hard-pressed in this case to characterize the wholesale abandonment of an existing, permissible interpretation of law as an error correction. Therefore, the IRS's ability to correct mistakes of law, see, e.g., Dixon v. United States, 381 U.S. 68, 72-75 (1965), is inapposite. See, e.g., Joseph Gann, Inc. v. Commissioner, 701 F.2d 3, 4 (1st Cir. 1983) (see Opp. 17-18) ("Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.") (quoting United States v. Correll, 389 U.S. 299, 305-06 (1967) (quoting Helvering v. Winmill, 305 U.S. 79, 83 (1938)) (emphasis added).

4. Turning to the extraordinary precedential import of this case in both the tax and other valuation areas, the Commissioner does not dispute the significance of the question of whether the IRS should be allowed to impose new interpretations of tax law retroactively to increase tax liability, a practice that is viewed as especially odious now in light of Congress' recent disapproval of retroactive tax liability.[3] Nor

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[3] Petitioners do not argue that the Taxpayers Bill of Rights 2, 26 U.S.C. §7805(b), applies on its own terms to the Commissioner's actions in this case. But the enactment of that law

does the Commissioner dispute that the same valuation standard the IRS uses in the estate and gift tax areas is also used in other substantive areas such as the valuation of ESOPs under the Department of Labor's regulations.

Rather, the Commissioner's only argument against the significance of this case is to again suggest that the decision is purely fact driven and does not involve a departure from prior IRS practice. The Commissioner cites several valuation articles in support of its position, but only one actually post-dates the court of appeals decision. (Opp. 18) (citing E. Giardina, The Gross Decision - Where Do We Go from Here, 5 Valuation Strategies 4, 7 (May/June 2002). However, in that article, contrary to the Commissioner's suggestions, the author recognizes that the IRS indeed has adopted a significant new approach in the Gross decision: "Because a decision accepting a 0% tax rate for an S corporation now exists, the IRS should be expected to attempt to use a 0% tax rate in all S corporation valuations, regardless of the percent of pretax income actually distributed, or the likely exit strategy." Id. (emphasis added).

This statement is consistent with one post-decision article cited by Petitioners, unmentioned by the Commissioner, that commented that all prior S corporation valuations, for tax purposes or otherwise, are now in question. (Pet. 2 n.1) (citing Hawkins & Paschall, A Gross Result in the Gross Case: All Your Prior S Corporation Valuations Are Invalid, Fair Value (Fall 2001)). Moreover, also confirming the prediction of the Giardina article, there is already evidence that the IRS is brandishing the Gross

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plainly shows Congressional discomfort with any attempt to raise a taxpayer's tax liability retroactively.

decision in other cases. (Pet. 12 n.3) (citing Adams v. Commissioner, T.C. Memo. 2002-80, 83 T.C.M. (CCH) 1421 (Mar. 28, 2002)).

Thus, IRS assertions to the contrary notwithstanding, the decision in Gross is being touted by the tax community as important and precedential with consequences that extend well beyond the parties and issues in this case. Indeed, in addition to the growing commentary about this case, eight separate and diverse amici have weighed in, viewing "the rulings at issue in this case as a serious threat to their members' appropriate interests in a predictable legal environment for tax planning and other financial transactions." Brief Amici Curiae of the National Association of Manufacturers et al. at 7 (filed July 19, 2002).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted and the decision below reviewed by this Court.

Respectfully submitted,

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